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William T. McCormick, Jr.
Chairman

May 15, 1997

The Honorable John Dingell
Ranking Member
Committee on Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman John Dingell:

Enclosed is Consumers Energy's response to your questions on electric utility restructuring. We appreciate the opportunity to share our views on this important and complex issue.

Consumers Energy supports state efforts to promote competition in the electric utility industry. In Michigan, we are working closely with the Michigan Public Service Commission, Governor Engler, the state legislature and other utilities and stakeholders to develop a plan which meets the unique characteristics and needs of Michigan and its citizens. We are optimistic that when this process is completed, we will have an electric industry which is financially healthy and provides safe, reliable and affordable electric service to all Michigan consumers.

However, we are very concerned about legislation pending in Congress that would supersede state restructuring efforts and impose unworkable federal standards and timetables. As you are aware, the electric utility industry differs from other industries which have undergone deregulation because it provides a basic service which the American people and our economy cannot live without. Given the vital role electricity plays in our daily lives, it would be unwise for Congress to act before it fully understands the implications of restructuring on reliability, electricity prices, the financial health of the industry, societal programs, the environment and a host of other issues.

Your efforts to survey the industry on these questions is an important and responsible step towards understanding the implications of restructuring and what if any role Congress should play in this debate. I commend you for your thoughtful and deliberate approach and look forward to continuing our discussions on this important public policy issue.

Sincerely,

Bill

1. **From your company's point of view, is it necessary for Congress to enact legislation bearing on retail competition, and why? If you favor legislation, please outline which issues should be addressed and how you think they should be resolved.**

Federal legislation mandating retail competition is unnecessary and inappropriate at this time. Michigan and 48 other states are actively considering retail competition and addressing the important and complex issues involved. Congress should not usurp the traditional authority of states to regulate retail electric markets. The states continue to be in the best position to determine the policies that meet their unique needs and circumstances. States and regions vary widely in terms of energy prices, customer and fuel mix, climate, population and demographics, environmental and societal programs and generation and transmission capacity. Federal legislation which establishes a one-size-fits-all policy for the nation would ignore these differences. And because states are adopting different time frames and approaches to retail competition, congressional action would likely complicate and confuse the restructuring process.

Michigan is faced with several unique situations. Our peninsular geography means limited interconnection capacity. Our long history of stringent environmental policies has blessed us with clean air, but has not been copied by utilities to our south whose coal-fired generating plants incur little transportation costs, and meet lower environmental standards. Utilities in other states to our south are awash in excess capacity. Michigan regulators and legislators are better equipped to recognize these issues during the transition.

Congress must give states the opportunity and flexibility to experiment with retail choice; to understand and address a variety of complex restructuring issues such as its impact on reliability of service, electricity prices, the industry's financial stability, the environment and service to rural areas and low-income families. States also are in a good position to take the lead on recovery of stranded costs arising from retail wheeling because utilities have incurred the majority of these costs at the direction of and with approval from their state regulators.

Nor is there any pressing need to enact comprehensive federal restructuring legislation. Based upon policies crafted in 50 different states, the United States has the most efficient and reliable electric system in the world and enjoys energy prices that are well below those of most other industrialized nations. As Charles Curtis recently observed, "this is not an industry in crisis -- at least not unless we make it

so." For Congress to rush through preemptive legislation that substitutes its judgment for the states and quashes or impedes state initiatives at the retail level at a time when they are flourishing would not only be arrogant, it would be irresponsible.

While Congress should defer to the states on the method and timing of retail competition, the focus of any federal restructuring bill should be on removing federal barriers that impede fair competition. Appropriate legislative changes include repeal of the Public Utility Holding Company Act (PUHCA), prospective repeal of the mandatory purchase obligation under the Public Utility Regulatory Policies Act (PURPA), elimination of federal subsidies, uneven taxation and preferences to government-owned and cooperative utilities competing with investor-owned utilities for new markets. Congress may also need to reaffirm the ability of states to require reciprocity of access to retail markets in order to increase competition.

If the state(s) you serve had adopted or is considering adopting retail competition, what are your biggest concerns? Please be specific. Indicate how you are dealing with them and any recommendations you may have.

Consumers Energy strongly supports Michigan's restructuring efforts and is working closely with the Michigan Public Service Commission (MPSC), the governor, the legislature and the state's other utilities and stakeholders to develop a plan which meets the interests of all Michigan citizens. The MPSC currently is considering a proposal issued by its staff last December, and as amplified by a specific filing made by Consumers in March 1997, that recommends a measured and progressive transition to retail competition.

The proposal phases in retail choice between 1997 and 2004, with all customer classes eligible to participate throughout the entire phase-in period. By 2004, all customers could choose their electric supplier. The plan calls for the full recovery of legitimate and prudently incurred stranded costs from departing customers. By phasing in retail choice over a seven-year transition period, the plan spreads out and reduces the impact of the stranded cost surcharge on departing customers. This transition period also provides Consumers Energy and the state's other utilities with the time they need to put into place the accounting, computer, metering and other operational and administrative systems necessary for retail competition. The MPSC staff plan also includes a comprehensive analysis of the state's transmission system and provisions to ensure the continued reliability of electric service.

As the restructuring plan is considered by the MPSC and the state legislature, Consumers Energy has several concerns which it feels must be addressed by the MPSC and state legislature:

One concern relates to the phase-in of retail access. Some parties have complained that the transition period for full retail competition is too slow and that all customers should be immediately provided with the ability to choose generation suppliers. As we have indicated above, a reasonable transition period to retail competition will spread out and reduce the amount of stranded costs which must be addressed by the departing customers. In addition, there are a host of billing, metering, administrative and policy issues which must be resolved in the course of providing customers with choice of generation suppliers. It is simply not feasible to expect that this could be accomplished in a reasonably efficient manner if all of Consumers Energy's 1.5 million retail electric customers were provided with immediate retail choice. As it is, the phase-in period recommended in the MPSC staff plan is an aggressive schedule which would be extremely challenging to meet.

A second major concern is stranded cost recovery. The opportunity to recover stranded costs is necessary to ensure a fair and smooth transition to a restructured electric industry. Under the Michigan plan, stranded costs have been defined to include costs incurred during the regulated era and pursuant to regulators' policies for recovery over extended periods of time that will not be collectible if service territories are immediately opened up to competing generation suppliers. Stranded costs also are defined as costs incurred to facilitate the transition from regulated monopoly status to competitive market status. These costs include regulatory assets, nuclear capital costs, purchased power costs, employee-related restructuring costs and costs related to restructuring such as those incurred to create an independent system operator and to establish the necessary billing system to accommodate retail access.

Recognition of commitments made under the current regulatory regime must be part of the transition to a more competitively oriented industry. Failure to account for these costs in the transition would be an unfair burden on the company's remaining customers and its shareholders. Denial of stranded costs also would raise the cost of capital for future investments, resulting in higher electric costs to consumers. The alternative of charging all stranded costs at one time is obviously not feasible.

A third major concern involves reciprocity, both with respect to in-state competitors and electric suppliers located in other states. The deregulation of generation service

within Michigan must include all Michigan utilities. Cooperative utilities which are regulated by the MPSC and municipal utilities which are not must be required to open up their systems to competition just as the state's investor-owned utilities have agreed to do. Likewise, contiguous states to Michigan whose electric suppliers wish to compete for Michigan customers must be prepared to provide Michigan utilities with retail access in their states. The MPSC staff plan includes strong reciprocity provisions which ensure uniform state-wide implementation of retail choice and prevent cherry picking of Michigan customers by generation sources from other states. Without strong intra- and inter-state reciprocity provisions, there can be no fair, competitive generation market and stranded costs would be substantially increased. Whether the interstate reciprocity provisions pass muster with the Commerce Clause in the context of electric restructuring remains to be tested. Congress may need to enact legislation reaffirming or granting states the authority to enforce reciprocity requirements.

A fourth concern involves transmission constraints or limitations on the ability to import power into the utility's system. Because it is a peninsula, Michigan's unique geography creates difficulties in assessing the future availability of transmission capacity. This assessment is further compounded by the limited interconnections between Michigan and Ohio, Indiana and Ontario. It is critical that these complex issues are understood and resolved if Michigan is to advance to a competitive electric industry without causing a negative impact on the reliability of today's system. Transmission and interconnection capacity also is critical to assuring a robust power supply market which is not subject to delivery constraints.

Finally, issues involving the sharing of costs for societal programs must be resolved. In a regulated environment, investor-owned utilities have acted as agents for state and federal programs that benefit low-income families and the environment and achieve other public policy goals. In a deregulated market, these costs must be shared by all participants in the market and not borne solely by the host utilities and their retail customers. Safeguards also must be put into place to ensure the beneficiaries of such programs continue to receive reliable and reasonably priced electric service.

3. **Whether or not you favor federal legislation, please indicate your position on the following specific issues (to the extent not addressed in your prior responses):**

a. *A Federal mandate requiring states to adopt retail competition by a date certain.* **If retail competition is under consideration in the state(s) you serve, do you believe Congress should provide additional direction or authority?**

Consumers Energy opposes a federal mandate requiring states to adopt retail competition by a date certain. As stated above, a federal mandate is unnecessary and inappropriate. Forty-nine states have adopted or are actively considering retail competition and are in the best position to determine the method and timing of restructuring for their citizens. Federal restructuring bills pending in the House and Senate (H.R. 655/H.R. 1230/S. 237) contain timetables and standards which directly conflict with, and would preempt the standards contained in the MPSC staff proposal on restructuring. States and their utilities need time to put into place new accounting, metering and other operational and administrative mechanisms to move from a regulated to a competitive marketplace. A reasonable transition period also amortizes utility stranded costs, diminishing their impact on departing customers.

Yet pending federal legislation that mandates retail competition by a date certain ignores these issues and instead sets arbitrary timetables which appear to be driven more by political imperatives than sound and considered public policy goals. Given the enormous stakes involved in restructuring, Congress should carefully consider and understand the implications of retail choice before acting. Permitting states to act as the laboratories for restructuring today and to address their unique circumstances will provide Congress with the data it requires to assess the need for and to develop federal restructuring policy in the future.

b. *Recovery of stranded investment.* **If the state(s) you serve already has adopted retail competition, how was this issue addressed and are you satisfied with the outcome? If your state(s) is considering adopting retail competition, how would you recommend that this issue be treated? Do you think Congress should enact legislation relating to stranded cost issues, and if so what would you recommend? Is securitization a useful mechanism for dealing with stranded costs, and whom does it benefit?**

As stated in our response to Question 2, the MPSC staff proposal recommends the recovery of legitimate and verifiable stranded costs. It also permits Michigan's utilities to recover the costs associated with implementing retail choice. These transition costs have been calculated by the MPSC staff in an

equitable manner that will protect the interests of utility customers and shareholders and ensure that the state's utilities remain financially healthy businesses and employers. The approval of all stranded costs is a precondition to Consumers Energy's support for retail access in Michigan. Contrary to statements by opponents of stranded cost recovery, these costs are not the result of poor management decisions by utilities. Costs that become stranded in a competitive environment, have all been found to be reasonable and prudent in various MPSC decisions in the regulated environment in which those costs were incurred. To deny recovery and require shareholders, thousands of whom are retirees and older people, to bear these costs would ignore past regulatory commitments and would simply be wrong.

With respect to the question of whether Congress should enact legislation relating to stranded cost issues, Consumers Energy believes that the states should take the lead in addressing stranded costs arising from retail wheeling because in most cases such costs are directly tied to the method and timing of retail competition. FERC Order 888 has developed a good methodology for wholesale and "retail-turned-wholesale" stranded cost recovery which Consumers Energy supports. What role, if any, Congress should play in addressing stranded costs will become clearer as wholesale and retail competition evolves over the next several years.

The Michigan plan includes a securitization proposal, which if properly implemented, would significantly benefit all customers and shareholders.

In fact, it would allow for an immediate rate reduction when a rate increase would otherwise be required to pay for scheduled and approved contract purchase cost increases. It would also allow for the correction of long-standing inter-class subsidies without a rate increase to any customer and afford more savings to customers exercising choice of supplier.

c. ***Reciprocity.*** **Can states condition access to their retail markets on the adoption of retail competition by other states? Should Congress enact such a requirement? Could such a requirement create an incentive for states with low electric rates not to adopt retail competition, in order to keep cheap power at home?**

As our response to question 2 acknowledged, Congress may have a role in clarifying the authority of states to promote competition through use of reciprocity requirements applicable to other states. It is unclear whether or not

such legislation is necessary. The ability of states to enforce such requirements in the context of state electric industry restructuring has not yet been specifically tested in the courts, principally because state retail access programs are so new.

In addition, as the pace of state restructuring efforts increases, the need for reciprocity requirements may disappear. As states adopt and implement retail competition, neighboring states will have a strong incentive to adopt similar programs in order to retain existing businesses and attract new investors. A case in point is New Jersey which is revisiting its earlier decision not to pursue retail choice after neighboring states approved restructuring plans and became magnets for new business investment. Like our response to the question of Congress' role on the stranded cost issue, the appropriate federal role on reciprocity will likely become clearer as state reciprocity provisions are tested in the courts and as state restructuring efforts move forward.

4. **If Congress enacts comprehensive restructuring legislation, should it mandate "unbundling" of local distribution company services? What effects would this have, and would they differ for various customer classes? Would this entail substantial expense, and who would incur any such costs?**

Local distribution company services should not be unbundled on a mandatory basis. There is potential for confusion among customers over transmission and electric supply unbundling. Let the market determine when and if local distribution services are ripe for unbundling.

Furthermore, distribution services unbundling would serve little purpose for the expense it would create. Billing systems which must be modified and created to handle generation and transmission unbundling will conservatively cost hundreds of millions of dollars for investor-owned utilities.

Unbundling of distribution services also creates more securitization credit risk by diffusing responsibility for revenue collection, potentially reducing the benefit of that mechanism in addressing stranded costs.

Adding the complication and expense of unbundling distribution services would be cumbersome for most customer classes and would be of negligible value to all but the largest commercial or industrial distribution customers who already have many service options available to them on an ad hoc basis.

5. **Recently Chair Moler of the Federal Energy Regulatory Commission recommended that, as part of comprehensive legislation, Congress authorize the Commission to enforce compliance with North American Electric Reliability Council standards to help maintain reliability of service. Do you believe this is necessary, and why or why not?**

Steps must be taken to ensure compliance with NERC, regional reliability council and other applicable state and local reliability standards. While most system operators will voluntarily adhere to reliability requirements, a few may attempt to "bend" those standards in order to gain a competitive advantage.

The problem of managing compliance will get worse as industry restructuring progresses. Traditional electric utilities will no longer serve all retail customer loads. Reliability standards must be made to apply to all load-serving entities whether they be power suppliers, national distribution companies or load aggregators. NERC or any alternative entity that is responsible for reliability must create a structure that will be effective in a changing industry.

NERC has taken action to strengthen its requirements by making compliance with its Operating Policies mandatory. NERC should establish appropriate reliability criteria and standards. The FERC should provide a mechanism not only for the enforcement of these standards but also to assure that the process for standards development is based on meeting technical requirements only -- not just a consensus of current practice.

There must be some mechanism for ensuring compliance with reliability standards by all segments of the industry. NERC, as a voluntary organization of stakeholders, does not have adequate enforcement tools. Not all stakeholders are subject to FERC jurisdiction and therefore may not be subject to any enforcement actions FERC might bring to bear. FERC's jurisdiction must be expanded to all owners and users of the transmission system if it is to be an effective guardian of system reliability.

6. **What concerns does your company have with respect to the role of public power and federal power marketing agencies in an increasingly competitive wholesale electric market? In markets in which retail competition has been adopted? Are there concerns you would like to have addressed if Congress enacts comprehensive restructuring legislation? Should Congress consider changes to federal law as it applies to regulation of public or federal power's transmission obligations?**

According to a recent Putnam, Hayes study, public power receives an estimated $8.7 billion in federal subsidies each year. Municipal utilities are exempt from federal and state income taxes as well as property, gross receipts and excise taxes. In addition, they have the ability to issue tax-exempt bonds and have preferential access to low-cost federal power. These subsidies amount to $5 billion annually. Rural cooperatives receive subsidies and competitive advantages amounting to $3.7 billion per year. These include exemption from federal taxes and most state and local taxes, federal loans and loan guarantees at interest rates below the cost of federal borrowing and preferential access to federal power.

The advantages municipal utilities and rural cooperatives enjoy are unfair and inappropriate in a competitive marketplace and should be rolled back. Many years ago, federal subsidies to rural cooperatives could be justified because they provided electricity to undeveloped, rural areas that were uneconomical to serve without government support. That situation has changed dramatically in more recent years. In Michigan, investor-owned utilities now compete head-to-head with municipal and cooperative utilities for new customers. Because of their tax advantages and lower cost of capital due to federal subsidies, municipal and cooperative utilities enjoy a significant competitive advantage over investor-owned utilities. This advantage will grow as Michigan and other states adopt retail restructuring plans and competition between utilities is unconstrained by state laws and service territories.

Not surprisingly, municipal and cooperative utilities aggressively defend their competitive advantage and point to a wide range of tax advantages enjoyed by investor-owned utilities. However, the difference is that, unlike the tax advantages and subsidies that public power utilities receive, federal and state tax codes have not carved out tax advantages specifically targeted to investor-owned utilities. IOUs receive tax treatment that is identical to the U.S. business community as a whole and would welcome municipal and cooperative utilities to forsake their special tax breaks and subsidies and join the greater business community in bearing both the benefits and burdens of the tax code.

Municipal and cooperative utilities also should be subject to the same transmission regulations as investor-owned utilities. These include FERC Order 888 requirements to file open access transmission tariffs, meet FERC's reciprocal transmission service rules and separate their transmission systems' transmission and marketing functions.

Federal restructuring legislation which fails to remove public power subsidies, uneven taxation, preferences and operational advantages omits an essential element that is indispensable to the development of a fully competitive marketplace.

7. **If Congress enacts comprehensive restructuring legislation, should changes be made to federal, state or local tax codes, and if so why? Please be specific.**

First, changes are needed in the tax laws at all three levels of government to bring about equal tax treatment for all electric competitors. Tax-free bond financing and income tax exemption should no longer be available to municipal utilities that are in competition with tax-paying investor-owned utilities. State and local property taxes, gross receipt taxes and sales taxes that apply in an uneven manner to investor-owned utilities relative to brokers, marketers, cooperative and municipal utilities and other electric competitors should be revised to eliminate the distortions they would cause in a competitive market.

Second, many utilities may find it necessary or desirable to restructure their ownership or operations, such as separating generation, transmission and distribution assets. Certain tax law provisions allow tax-free transactions to accomplish this, but some of those provisions, such as spinoffs, have recently come under attack. These tax-free transactions should continue to be available to permit the efficient restructuring of electric utilities.

8. **What, if any, concerns do you have about the reliability of the electric system? If the industry moved to retail competition, will adequate reserves be available? Is the transmission system capable of handling full retail competition?**

There is increasing evidence that the reliability of the transmission system is being threatened by the uses of the system that have been spawned by implementation of FERC Orders 888/889. Transmission service transactions routinely involve up to a dozen parties and cross several control areas. Power merchants are finding ways to put together power deals that were not thought of nor necessary in years past. Control area operators are finding it difficult to determine exactly where the power is coming from and which systems are carrying it. There are many more users of the transmission system. The uses being made of the system today are far different than the purpose for which it was built. Planning for transmission expansion is difficult because it is unclear exactly how the system will be used. Transmission expansion is becoming increasingly difficult as a result of regulatory and legal intervention conducted by activists of all persuasions.

Power supply reliability is definitely a concern for the future. Because of regulatory uncertainty, few, if any, utilities are willing to construct new large base load power plants. Most of the new generation being constructed today in the Midwest are small size peaking facilities that are designed to operate during a few peak load hours of the year. Utilities short of generating capacity are relying on regional base load surpluses to meet their needs. This strategy will be successful until the point where those surpluses are no longer available due to load growth in the utility's system or the shut down of existing generating plants. The market will then support the cost of constructing new generation, but it takes several years to build a new power plant. The issue is whether the market will provide appropriate price signals in time for new generation to be available when needed. It is highly likely that there will be instances where firm customer load must be curtailed because the utility or third-party supplier did not judge the market situation correctly. The reliability of the overall system will be compromised because one deficient system affects its neighbor.

Consumers is in the midst of a pilot direct access program for large commercial and industrial customers and is gaining considerable insight into the requirements imposed by such programs on the transmission system. The complexities of such a program are too numerous to describe here. It is clear, however, that the capabilities of Consumers' interconnections with neighboring utilities are insufficient to meet all of our load requirements. Such interconnection capability would similarly be insufficient if all of our existing customer load contracted for its power supply from sources external to Michigan. While no one can accurately predict how the transmission system will be used in full retail competition, it is very likely that limitations will result from uses of the system that are not known today.

9. **If Congress enacts legislation on retail competition, should changes to the Public Utility Holding Company Act of 1935 (PUHCA) be included? If so, what would you recommend? In particular, how should Congress address market power concerns in any such legislation? Are transition rules needed during the period before effective competition becomes a reality?**

Whether proposed retail competition is enacted into law, or not, the Holding Company Act should be repealed.

When PUHCA was enacted in 1935, Congress faced a genuine threat of harm to utility customers, investors and lenders as a result of the financial manipulation of groups of utilities under common control of an unscrupulous entrepreneur. The specific incentive of Congress to consider the '35 Act was the financial collapse of

several big holding companies and their affiliated utilities in the late 20's and early 30's, owing to over-leverage and general overpricing of equity securities attributable to investor ignorance. Concerns over monopoly power, price collision or other anticompetitive effects were not expressed at the time, nor was the Act intended to address these types of concerns.

Since the collapse of the utility stocks in the years 1929-1933, many protections which did not exist at the time have become commonplace, including protections of the Securities Act of 1933, the Exchange Act of 1934 and volumes of new state laws and regulations, and including modern accounting and audit practices, the creation of the securities analysis industry and techniques and, of course, modern means of instantaneous and universal communication.

Concerns over the existence and abuse of market power have never been limited to the utility industry; they are equally valid in the context of manufacturing, finance, insurance or consumer goods. In response specifically to those threats, Congress has enacted over the years the Sherman, Clayton, Robinson-Patman and Federal Trade Commission Acts and each of these has been mirrored in the laws of most states. In addition, state utility commissions are ever watchful for abuse and, through their rate-making power (and in many cases, their authority over mergers), are able to prevent abuses. Furthermore, the FERC, under the power granted it in Section 203 of the Federal Power Act, has the authority to prevent combinations of utilities which it, after notice to affected states, finds not to be in the public interest.

In short, PUHCA is designed to meet a need which no longer exists and should be repealed. Other laws, designed specifically to prevent abuse of market power, will remain in full force.